

Explanation of the Discussion Draft, California Code of Regulations, title 18, section 25110, subsection (d)(2)(F)3. Deduction.

Attached is a discussion draft of a proposed addition to the regulation addressing the manner in which deductions with respect to non-effectively connected income of a foreign corporation included in a water's-edge combined report pursuant to Revenue and Taxation Code section 25110, subdivisions (a)(4) or (a)(7)(B) are to be determined.

Under Revenue & Taxation Code section 25110(a)(4), a foreign corporation with less than 20 percent average U.S. factors, or a foreign bank, is included in a water's-edge combined report to the extent of its U.S. source income and factors. When regulations were first promulgated to provide guidance for this rule, the Franchise Tax Board (FTB) defined United States income to mean the income that is effectively connected with a U.S. trade or business (ECI) under the provisions of the Internal Revenue Code (IRC). California Code of Regulations, title 18 (CCR), section 25110(d)(2)(F)3, also stated that deductions attributable to United States income shall be determined by the allocation and apportionment rules set forth in Treasury Regulation (TR) sections 1.861-8 (other than interest expense) and 1.882-5 (interest expense).

Effective for taxable years beginning on or after January 1, 1992, the California regulations expand the scope of United States income to include not only ECI, but also U.S. source business income that is not effectively connected with a U.S. trade or business (NECI). However, the FTB regulations related to the deductions attributable to United States income remain unchanged.

Under IRC section 882(a), except to the extent provided by treaty, foreign corporations are subject to U.S. *net basis* taxation on ECI. Foreign corporations with ECI may also be subject to a branch profits tax. Under IRC section 881(a), foreign corporations' U.S. source NECI is subject to a *gross basis* tax at a flat tax rate of 30 percent unless reduced or eliminated by treaty. Therefore, there are no federal rules to determine deductions for NECI. Consequently, for federal purposes, TR sections 1.861-8 and 1.882-5 specifically do not apply in the determination of deductions for U.S. source NECI, which is taxed at gross.

Therefore, an amendment to California Code of Regulations, title 18, section 25110(d)(2)(F)3, is necessary to provide guidance in determining the deductions attributable to non-effectively connected income of a foreign corporation that is included in a water's-edge combined report.